



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

**DRAFT**

Date Introduced	<b>04/01/02</b>	Bill No:	<b>SB 1890</b>
Tax:	<b>Cigarette and Tobacco Products</b>	Author:	<b>Ortiz</b>
Board Position:		Related Bills:	

**BILL SUMMARY**

This bill would impose an additional excise tax on cigarettes of 32.5 mills per cigarette, or 65 cents per package of 20, impose an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and impose an equivalent compensating floor stock tax, operative January 1, 2003. The revenue from the tax increase would be deposited into the Tobacco Use Reduction and Compensation Fund, as created by this bill.

**ANALYSIS**

**Current Law**

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes and based on the March 1 wholesale cost of tobacco products. The surcharge rate from July 1, 2001 through June 30, 2002 is 52.65%.

Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children and Families First Trust Fund (CCFF Trust Fund). The tobacco products surtax imposed under Section 30123 is deposited into the Cigarette and Tobacco Products Surtax Fund, while the surtax imposed under Section 30131.2 is deposited into the CCFF Trust Fund.

**Proposed Law**

Among other things, this bill would add Article 4 (commencing with Section 30132) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of 65 cents per package of 20 cigarettes, in addition to an equivalent tax on tobacco products. The tax would be imposed beginning January 1, 2003. The bill

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would also impose a compensating floor stock tax on the January 1, 2003 cigarette and tobacco products inventory of a dealer and distributor.

This bill would require that the additional cigarette and tobacco products taxes imposed be adjusted annually and indexed to the medical care component of the United States Department of Labor Consumer Price Index for California.

The proceeds from the tax increase would be deposited by the Controller into the Tobacco Use Reduction and Compensation Fund, which this bill would create. The taxes deposited into the fund would be allocated and appropriated for health and tobacco prevention and cessation programs.

### Background

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, passed November 3, 1998, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

### COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the American Lung Association of California, American Cancer Society (California Division) and the American Heart Association (Western States Affiliate) and is intended to reduce the human and financial costs of tobacco use by simultaneously creating a disincentive to smoke through the tax. In addition, it would: 1) provide means to help smokers quit through new tobacco control and cessation services, 2) provide an additional half billion dollars for smoking related medical research, and 3) pay for medical costs for the working poor.
2. **Summary of amendments.** Amendments to this bill changed the tax on a package of 20 cigarettes from 70 cents to 65 cents, and added the requirement that the proposed additional cigarette and tobacco products tax be adjusted annually and indexed to the medical care component of the United States Department of Labor Consumer Price Index for California. Further, the amendments revise the allocation of moneys deposited into the Tobacco Use and Consumption Fund.
3. **This measure would increase the excise tax on tobacco products in two ways.** First, this bill would create a new tobacco products tax equivalent to the 65 cent

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cigarette tax pursuant to Revenue and Taxation Code Section 30132.1. Second, this measure would increase the Proposition 99 excise tax on tobacco products by increasing it to be equivalent with not only the 87 cent per package cigarette tax, but also the 65 cent per package cigarette tax increase proposed in this bill. The latter would occur because any increase in the cigarette tax rate imposed under Part 13 of the Revenue and Taxation Code also automatically triggers an equivalent tax increase on other tobacco products pursuant to Section 30123 (Proposition 99). Accordingly, the additional excise tax on tobacco products would be equivalent to a \$1.30 per pack cigarette tax increase (\$0.65 pursuant to proposed Section 30132.1(b) and \$0.65 pursuant to Section 30123(b)).

4. **This measure would increase state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the sale is subject to sales or use tax unless specifically exempted or excluded by law. Because excise taxes on cigarette and tobacco products are not specifically exempted or excluded, they are included in the total amount of the sale and subject to sales or use tax. Since this measure increases the excise tax on cigarettes and other tobacco products, the amount of the sale of these products to which the sales or use tax applies would also increase. The impact this bill would have on state and local sales and use tax revenues is discussed in the Revenue Estimate.
5. **The proposal should contain an appropriation and reimbursement language.** This bill would require the Board to begin collecting the tax effective January 1, 2003, which is in the middle of the state's fiscal year. In order to be able to administer and collect the tax, the bill should be amended to provide an appropriation to the Board. Without an appropriation, consideration should be given to changing the operative date of the cigarette tax increase to July 1, 2003 to become effective at the beginning of the fiscal year and to coincide with the budget development process.

Additionally, in order for the Board to be adequately compensated for the cost of administering this proposal in subsequent fiscal years, language should be added to authorize reimbursements from the funds collected before the tax is deposited in the Tobacco Use Reduction and Compensation Fund. Language should also be added to authorize the payment of refunds for overpayments from moneys collected.

6. **This bill appears to contain floor stock tax provisions.** Proposed Section 30132.1 contains language which appears to impose a floor stock tax on a dealer's and a distributor's inventory. It is suggested, however, that more specific language for a floor stock tax be added to the bill, which Board staff would be willing to provide.

A floor stock tax is important because it equalizes the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase. Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes can be raised and attributed to the rate increase, but the additional funds collected are profit and not an excise tax paid to the state. A floor stock tax mitigates this windfall.

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As an example of the impact of not having a floor stock tax, in apparent anticipation of the tax increase of 2 cents per package of 20 cigarettes for funding breast cancer research projects beginning in January 1, 1994, sales of cigarette stamps jumped by \$34.8 million in December 1993, or enough stamps for 99 million packs of cigarettes. There was a corresponding decrease in the number of stamps purchased in January and February 1994. Because distributors had an adequate inventory of 35 cent cigarette stamps on hand to affix to their cigarette packages, they could delay for months having to buy the 37 cent stamps which were sold beginning January 1, 1994. This huge inventory stockpiling translated into \$2 million in lost revenue for the Breast Cancer Fund, money which had been anticipated as part of the original revenue estimate.

While there are additional costs associated with administering the floor stock tax, the revenue substantially compensates for that cost.

7. **Would an increase in the cigarette tax increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. In 1999, Board staff spent considerable time developing a variety of statistical approaches to estimate cigarette tax evasion. In addition, Board staff reviewed numerous studies of behavioral responses of smokers to price changes as well as studies that estimated tax evasion. Using a baseline statistical model, Board staff estimated that cigarette tax evasion in California was running at annual amount rates of approximately \$130 to \$270 million. The estimate was only for evasion of excise taxes, and did not include associated evasion of other taxes, such as sales and use or income taxes. A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates.

Two major events that occurred since November 1998 have dramatically increased California excise taxes as well as cigarette prices excluding taxes: Proposition 10 and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose an additional excise tax on cigarettes of 32.5 mills per cigarette, or 65 cents per package of 20, and impose an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax. It is assumed that this increase would cause a correlated increase in tax evasion based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement. The Revenue Estimate discusses the impact this bill would have on excise tax revenues associated with tax evasion.

8. **This bill would require an annual adjustment of the cigarette tax and the tobacco products tax.** Specifically, the taxes imposed pursuant to this measure would be adjusted annually and indexed to the medical care component of the United States Department of Labor Consumer Price Index for California. However, there is no "medical care component" specific to the California consumer price index.

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In addition, these provisions are vague as currently written. For example, the bill does not specify months of the index (if applicable) or whether an annual average or a point-to-point (monthly) estimate is to be used.

This bill also does not specify a date for the yearly calculation. It should be noted that the medical care component of the U.S. consumer price index data is generally available by March of each year. In addition, it should be noted that when specifying the date of the yearly calculation that the tobacco products tax rate is currently adjusted each fiscal year. It is recommended that any adjustment to the tobacco products tax rate pursuant to this measure coincide with the effective date of the current tax rate adjustment.

9. **Suggested technical amendments** The following technical amendments are necessary to reference the current sections of law pertinent to the imposition of the cigarette and tobacco product taxes:

30132.1. (a) In addition to the taxes imposed upon the distribution of cigarettes by Article 1 (commencing with Section 30101) and Article 2 (commencing with Section 30121) and any other taxes in this chapter, there shall be imposed an additional surtax upon every distributor of cigarettes at the rate of thirty-two and one half mills (\$0.0325) for each cigarette distributed.

(b) In addition to the taxes imposed upon the distribution of tobacco products by Article 1 (commencing with Section 30101) and Article 2 (commencing with Section 30121), and any other taxes in this chapter, there shall be imposed an additional tax upon every distributor of tobacco products, based on the wholesale cost of these products, at a tax rate, determined annually by the Board of Equalization, which is the equivalent to the tax imposed on cigarettes by subdivision (a).

(c) The taxes imposed by this section shall be imposed on every cigarette and on all tobacco products in the possession or under the control of every dealer and distributor on and after 12:01 a.m. on January 1, 2003, pursuant to rules promulgated by the State Board of Equalization.

In addition to the suggested change above, the following technical amendment is necessary to specify the basis for determining the tobacco products tax, as well as its effective date:

30132.3. The annual determination required of the State Board of Equalization pursuant to subdivision (b) of Section 30132.1 shall be made based on the wholesale cost of tobacco products as of March 1, and shall be effective during the state's next fiscal year.

## **COST ESTIMATE**

The Board would incur costs related to this measure for notifying potential feepayers, developing returns, computer programming, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax. A cost estimate of this workload is pending.

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**REVENUE ESTIMATE****Background, Methodology, and Assumptions****Fiscal Year 2002-03**

**Cigarette Tax.** Tax-paid cigarette distributions were 1,288 million packs in fiscal year 2000-01, down about 5 percent from 1999-00. According to the 2002-03 *Governor's Budget Summary*, total cigarette consumption is estimated to decline in the range of 3 percent annually in the next few years. Consumption is estimated to be 1,212 million packs in fiscal year 2002-03, (1,288 million packs  $\times$  0.97  $\times$  0.97 = 1,212 million packs) Consumption for the period January 1, 2003 through June 30, 2003 is estimated to be 606 million packs. However, an increase in the tax rate as large as the one proposed by this bill would surely cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause an additional decrease of 8 percent in tax paid distributions. (This estimate assumes a price elasticity of demand of -0.50, applied to estimated average 2001 prices of approximately \$4.00 per pack.) Therefore, the estimated taxable distributions subject to this proposal for the period January 1, 2003 through June 30, 2003 would be 558 million packs. (606 million packs  $\times$  0.92 = 557.5 million packs)

The current tax rate on cigarettes is \$0.87 per pack. A 65 cents per pack increase would result in increased excise tax revenues for fiscal year 2002-03 as follows:

	Packs (millions)	Rate (per pack)	Revenue (millions)
Current Rate	606	\$0.87	\$527.2
Proposed Rate	558	\$1.52	<u>\$848.2</u>
Difference			\$321.0

A corresponding floor stock tax, assuming a three weeks supply of cigarettes, approximately 64 million packs ((558/26)  $\times$  3 = 64.4), would produce \$41.9 million in additional revenue. (64 million packs  $\times$  \$0.65 = \$41.9 million).

**Tobacco Products Tax.** This measure would impose an additional tax on tobacco products at a rate equivalent to the new 65-cent per pack rate this measure would impose on cigarettes. This tax increase would be effective on January 1, 2003.

The effective tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2001-02 fiscal year is \$0.1301. According to the latest data available from the U.S. Bureau of Labor Statistics, cigarette prices increased 8.9 percent from November 2000 to November 2001. Applying this price increase to fiscal year 2002-03, the average cost per cigarette for the 2002-03 fiscal year is estimated to be \$0.1417 (0.1301  $\times$  1.089 = 0.1417). (This is an estimate, subject to revision when USDA publishes 2001 cigarette prices later this Spring.) The current tax rate on cigarettes is \$0.0685 per cigarette.

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The tobacco tax rate for 2002-03 is estimated to be approximately 48.3 percent ( $\$0.0685 / \$0.1417 = 0.4834$ ).

For purposes of calculating the tobacco products tax rate, the proposed tax rate on cigarettes would increase to \$0.1010 per cigarette (\$2.02 per pack, comprised of the current rate of \$1.37 per pack plus the rate increase of \$0.65 per pack;  $2.02 / 20 = 0.1010$ ).<sup>1</sup> This would increase the 2002-03 tobacco products tax rate to 71.3 percent ( $\$0.1010 / \$0.1417 = 0.7128$ ).

The wholesale cost of tobacco products was \$90.6 million during the 2000-01 fiscal year, down about 5 percent from 1999-00.<sup>2</sup> It would be reasonable to expect continued declines of 3 percent per year, similar to the long term trend for cigarette consumption. Using this assumption, estimated wholesale costs of tobacco products will be about \$85.2 million in fiscal year 2002-03 ( $\$90.6 \times 0.97 \times 0.97 = \$85.2$ ). For the period January 1, 2003 through June 30, 2003 wholesale costs would be \$42.6 million. ( $\$85.2 \text{ million} / 2 = \$42.6 \text{ million}$ ).

However, an increase in the tax rate as large as the one proposed by this bill would surely cause both a decrease in actual consumption and an increase in tax evasion. Tax evasion is a larger problem with tobacco products than with cigarettes. Tax indicia, which are one disincentive to evaders, are not required for tobacco products. As mentioned earlier, at \$0.1417 per cigarette, the estimated wholesale cost of cigarettes would be \$2.83 per pack in 2002-03. Assuming a price elasticity of demand of  $-0.50$ , we would expect an additional decline of about 11 percent in tobacco products sales in 2002-03 resulting from the consumer behavior response to the SB 1890 tax increase ( $(\$0.65 / \$2.83) \times 0.50 = 0.1148$ ). Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause a decrease of 11%. Therefore, the estimated wholesale cost of tobacco products subject to this proposal for the period January 1, 2003 through June 30, 2003 would be \$37.9 million. ( $(\$85.2 \text{ million} / 2) \times 0.89 = \$37.91 \text{ million}$ ).

The increase in tobacco products tax revenue for fiscal year 2002-03 would be as follows:

	Wholesale Cost (millions)	Rate	Revenue (millions)
Current Rate	\$42.6	48.3%	\$20.6
Proposed Rate	\$37.9	71.3%	<u>\$27.0</u>
Difference			\$6.4

A corresponding floor stocks tax, assuming a three weeks supply of tobacco products, would produce \$1.0 million in revenue,  $((37.9 / 26) \times 3 \times (0.713 - 0.483) = \$1.0 \text{ million})$ .

<sup>1</sup> The current effective rate of \$1.37 per pack for tobacco products consists of \$0.87 per pack related to Proposition 99 and \$0.50 related to Proposition 10.

<sup>2</sup> Source: BOE Excise Taxes Division. Cited in a memo from Dave Hayes to Board Members, November 9, 2001, "Effects of Proposition 10 on Cigarette and Tobacco Products Consumption."

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**Fiscal Year 2003-04**

**Cigarette Tax.** A 65-cents per pack increase would result in increased cigarette tax revenues for fiscal year 2003-04 as follows:

	<u>Packs</u> <u>(millions)</u>	<u>Rate</u> <u>(per pack)</u>	<u>Revenue</u> <u>(millions)</u>
Current Rate	1,176	\$0.87	\$1,023.1
Proposed Rate	1,082	\$1.52	\$1,644.6
Difference			\$621.5

**Tobacco Products Tax.** As mentioned earlier, existing law imposes a tax on tobacco products equivalent to the tax rate on cigarettes. The cigarette tax increase imposed by this measure would be included in the equivalent tax rate subject to the existing tobacco products tax. The impact of the proposal is to increase the effective tobacco products tax by a rate equivalent to a \$1.30 per pack increase in the cigarette tax, effective July 1, 2003. This is 65 cents more than the January 1, 2003 increase. The July 1, 2003 total effective tax on tobacco products would be \$2.67 per pack (current rate of \$1.37 per pack plus \$1.30 per pack). With the wholesale cost of \$0.1437 per cigarette discussed earlier, the 2003-04 tobacco products tax rate would go to 94.2 percent ( $\$2.67 / 20 = \$0.1335$ ;  $\$0.1335 / \$0.1417 = 0.9421$ ).

The increase in tobacco products tax revenue for fiscal year 2003-04 would be as follows:

	<u>Wholesale</u> <u>Cost</u> <u>(millions)</u>	<u>Rate</u>	<u>Revenue</u> <u>(millions)</u>
Current Rate	\$82.6	48.3%	\$39.9
Proposed Rate	\$63.6*	94.2%	\$59.9
Difference			\$20.0

**Sales and Use Tax**

The total increase in excise tax revenues would be \$390.6 million for fiscal year 2002-03 and \$672.1 for fiscal year 2003-04. If all of these taxes are passed on to the ultimate consumer, there would be an increase in state and local sales and use tax revenue as follows:

	<u>Increased Revenue</u>	
	<u>2002-03</u>	<u>2003-04</u>
State (5%)	\$18.5 million	\$32.1 million
Local (2.25%)	\$8.3 million	\$14.4 million
Transit (0.67%)	\$2.5 million	\$4.3 million
Total	\$29.3 million	\$ 50.8 million

\* Assumes a 23% decrease in taxable tobacco products due to decreased consumption and increased tax evasion because of the additional tax rate effective on July 1, 2003, ( $\$1.30 / 2.83 \times 0.50 = 0.230$ ).

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**Fiscal Year 2004-05 and Beyond**

The medical care component of the U.S. consumer price index (CPI) increased 54 percent in the ten-year period from 1991 through 2001, an average of about 4.4 percent per year.<sup>3</sup> (This is far above the 2.7 percent average increase per year of the overall U.S. CPI.) The indexing component of this bill would cause an increase in the 65-cent per pack tax of approximately 3 cents per year based on this historical average. Using this historical average and ignoring annual compounding of rounding errors, the tax rate would increase from 65 cents per pack in 2003 to \$1.00 per pack by 2013. There would also be declines in consumption according to the price elasticity of demand that would be appropriate for such a level of excise tax.

**Revenue Summary**

Increasing the Cigarette Tax by 65 cents per pack and imposing an equivalent rate on other tobacco products would result in the following revenue increase for the 2002-03 fiscal year (half-year only) and the 2003-04 fiscal year:

	<u>2002-03</u>	<u>2003-04</u>
Cigarette Tax Revenue Increase	\$ 321.0 million	\$ 621.5 million
Floor Stocks Tax	\$ 41.9 million	
Other Tobacco Tax Revenue Increase	\$ 6.4 million	\$ 20.0 million
Floor Stocks Tax	\$ 1.0 million	
State Sales & Use Tax ( at 5%)	\$ 18.5 million	\$ 32.1 million
<b>Total State</b>	<b>\$ 388.8 million</b>	<b>\$ 673.6 million</b>
 Local Sales & Use Tax (at 2.25%)	 \$ 8.3 million	 \$ 14.4 million
Transit Tax (at 0.67%)	\$ 2.5 million	\$ 4.3 million
<b>TOTAL</b>	<b>\$ 399.6 million</b>	<b>\$ 692.3 million</b>

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<sup>3</sup> Historical data for the medical care cost component of the California consumer price index are not readily available. However, California medical care costs have increased at approximately the same rate as U.S. medical care costs since the 1982-1984 base period.

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